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[JOINT COMMITTEE ON TAXATION]

DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES (H.R. 11, H.R. 23, AND OTHER PROPOSALS)

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JUNE 25 AND JULY 11, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled public hearings on June 25 and July 11, 1991, on H.R. 11 ("Enterprise Zone Tax Incentives Act of 1991"), H.R. 23 ("Enterprise Zone Jobs-Creation Act of 1991"), and other proposals relating to enterprise zone tax incentives.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the enterprise zone proposals. Part I is a summary. Part II is a brief description of related present-law provisions. Part III is a description of the provisions of H.R. 11, H.R. 23, and other proposals relating to enterprise zones, including H.R. 1445 ("Rural Development Investment Zone Act of 1991") and H.R. 1747 ("Indian Economic Development Act of 1991"). Part IV discusses issues relating to proposed tax incentives for economic activity located in enterprise zones.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Proposals Relating to Tax Incentives for Enterprise Zones (H.R. 11, H.R. 23, and Other Proposals)* (JCS-9-91), June 18, 1991.

I. SUMMARY

Present Law

Tax incentive provisions

Targeted geographic areas

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, the provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas. Similarly, for purposes of the low-income housing credit, certain geographic areas are designated as high cost or difficult to develop areas for the purpose of increasing the rate of credit applicable to such areas. In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States as a means to encourage the conduct of trades or businesses within these areas.

Tax credits for employers

Under present law, the income tax liability of an employer does not vary based on where an employee performs services on behalf of the employer. The targeted jobs tax credit under present law, however, provides an income tax credit to employers for a portion of the wages paid to certain employees, who generally are either economically disadvantaged or participating in a specific education or rehabilitation program.

Tax credits for employees

Under present law, the income tax liability of an employee does not vary based on where the employee performs services in the United States on behalf of an employer. However, an eligible individual who maintains a home for one or more qualifying children is allowed an advance refundable income tax credit based on the earned income of the individual and the number of qualifying children.

Tax credits for investment

An income tax credit is allowed under present law for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings that were originally placed in service before 1936. In addition, under present law, an income tax credit is allowed in annual installments over 10 years for certain expenditures incurred in substantially rehabilitating or constructing qualifying low-income rental housing. Under prior law, a 10-per-

cent investment tax credit was allowed for the cost of eligible tangible personal property that was used in a trade or business or for the production of income.

Capital gains

Net capital gains are taxed as ordinary income under present law, subject to a maximum marginal rate of 28 percent in the case of individuals. Before 1987, net capital gains were taxed at a reduced rate. All taxpayers other than corporations could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20-percent tax rate. The maximum tax rate for net capital gains of corporations was 28 percent.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided for what are termed private activity bonds. These include bonds issued as qualified small-issue bonds, as qualified redevelopment bonds, or to finance certain other private activities. Tax-exempt private activity bonds generally are subject to State volume limitations.

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on goods imported into a foreign trade zone until the time that the goods leave the foreign trade zone for shipment to other areas of the United States.

Regulatory flexibility

Under present law, government agencies must follow certain procedures in promulgating regulations that are designed to ease the regulatory burden on small businesses, small nonprofit organizations, and small governmental jurisdictions.

Summary of H.R. 11

Designation of tax enterprise zones

H.R. 11 would establish a demonstration program by authorizing the Secretary of Housing and Urban Development to designate 25 tax enterprise zones from areas nominated by State and local governments. The designations would be made during calendar years 1992 through 1995 with generally no more than 10 designations in 1992 and no more than five designations in any other calendar year. The designation of an area as a tax enterprise zone generally would be effective for 24 calendar years after the calendar year in which the area was originally designated as a tax enterprise zone.

Tax incentives for tax enterprise zones

Employment tax credit

The bill would provide certain small employers with an enterprise zone employment credit equal to 10 percent of the sum of (1)

the qualified zone wages paid or incurred during a taxable year and (2) the qualified zone employee health insurance costs paid or incurred during the taxable year. For this purpose, qualified zone wages would be defined as wages that are paid or incurred by a small employer for services performed by a qualified zone employee. Qualified zone employee health insurance costs would be defined as amounts paid or incurred by a small employer for health insurance coverage of a qualified zone employee.

Rehabilitation tax credit

Under the bill, a building that is located in a tax enterprise zone on the date that rehabilitation begins would qualify for the rehabilitation tax credit if there were a period of at least 30 years between the date that the building was first placed in service and the date that the rehabilitation begins.[2]

60-month amortization of child care facilities

The bill would allow the amortizable basis of a qualified child care facility to be recovered ratably over a 60-month period (beginning with the month that the facility is placed in service) in lieu of the depreciation deductions allowed under present law.

Low-income housing tax credit for enterprise zone child care centers

For purposes of the low-income housing tax credit, the bill would increase the qualified basis of a qualified low-income building that is located in a tax enterprise zone by the amount of the eligible basis of the building that is used as a qualified child care center.

Capital gain deferral for reinvestment in zone property

The bill would allow individuals to defer the recognition of any long-term capital gain from the sale or exchange of any property up to 9 taxable years after the taxable year in which the sale or exchange occurs if the amount realized from the sale or exchange is used to purchase qualified zone property within one year after the close of the taxable year of the sale or exchange.

Treatment of losses on investments in qualified zone corporations

The bill would treat any loss from the sale or exchange of a qualified zone corporate investment as an ordinary loss rather than a capital loss.

Limitation on tax incentives

The bill would impose a limit on the amount of tax incentives that are available in each tax enterprise zone for each calendar year. The local governments and the State in which a tax enterprise zone is located would be required to designate a government official who is to be responsible for allocating the tax incentives of

[2] In order for a building other than a certified historic structure to qualify for the rehabilitation tax credit under present law, the building must have been first placed in service before 1936.

the zone among taxpayers and for ensuring that the annual limit on the amount of tax incentives of the zone is not exceeded.

Alternative minimum tax

Under the bill, enterprise zone tax incentives would not apply for purposes of the alternative minimum tax.

Effective date

The tax provisions generally would be effective on the date of enactment.

Other provisions

Preference in establishment of foreign trade zones

The bill would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in a tax enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in a tax enterprise zone.

Studies

The bill would require the Secretary of the Treasury and the Comptroller General to conduct separate studies on the effectiveness of the incentives provided by the bill in achieving the purposes of the bill. A report of each study would be required to be submitted not later than July 1, 1995, to the House Committee on Ways and Means and the Senate Committee on Finance.

Summary of H.R. 23

Designation of enterprise zones

H.R. 23 would authorize the Secretary of Housing and Urban Development to designate up to 50 enterprise zones from areas nominated by State and local governments. The designations would be made over a four-year period, with not more than 15 designations being made during each of the first three years, and 5 in the last year. The designation of an area as an enterprise zone generally would be effective for 25 years.

Tax incentives for enterprise zones

Employment tax credit

The bill would provide a 5-percent refundable tax credit to enterprise zone employees for the first $10,500 of wages. The maximum credit would be $525; it would be phased out between $20,000 and $25,000 of total wages. The credit would be reduced for individuals subject to the alternative minimum tax.

Exclusion of enterprise zone capital gain

The bill would exclude from income certain long-term capital gain realized from the disposition of enterprise zone property. The property must have constituted enterprise zone property for at

least two years prior to disposition. The gain exclusion would not be a preference for purposes of the alternative minimum tax.

Deduction for purchases of enterprise zone stock

Under the bill, individuals could elect to deduct up to $50,000 per year of the purchase price of enterprise zone stock, subject to a $250,000 lifetime limitation. Any gain on the sale of the stock would be recaptured as ordinary income. In addition, the tax benefit of the deduction would be reduced if the stock were held less than five years when sold. The deduction would be treated as a preference for purposes of the alternative minimum tax.

Effective date

The tax provisions generally would be effective for taxable years ending after December 31, 1990.

Other provisions

Preference in establishment of foreign trade zones

The bill would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in an enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in an enterprise zone.

Regulatory flexibility

The bill would expand the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified enterprise zone business, and certain other enterprises.

Repeal of Title VII of 1987 Housing Act

The bill would repeal Title VII of the Housing and Community Development Act of 1987.

Summary of H.R. 1445

Designation of rural development investment zones

H.R. 1445 would authorize the Secretary of the Treasury to designate up to 100 rural development investment zones. Zone designations would remain in effect for up to 12 years.

Tax incentives for rural development investment zones

Wage tax credit

The bill would provide to employers in rural development investment zones a 10-percent tax credit for certain wages paid to qualified employees. The credit would apply to only the amount of qualified wages paid during the taxable year which exceeds the amount of qualified wages paid during the preceding 12-month period. Qualified wages with respect to any qualified employee would be limited to 2.5 times the amount of wages subject to Federal unemployment (FUTA) tax (currently $7,000).

Investment tax credit

The bill would provide a 10-percent tax credit for depreciable real property which in placed in service and located in (and used predominantly in the active conduct of a trade or business in) a rural development investment zone. The credit rate for new placed-in-service property would be phased out during the last several years that the designation of an area as a rural development investment zone remains in effect.

Effective date

The wage tax credit would be effective for taxable years beginning after December 31, 1990. The investment tax credit would apply to periods after December 31, 1990, under rules similar to prior law section 48(m).

Other provisions

The bill would expand the definition of small entity for certain entities within rural development investment zones for purposes of the Regulatory Flexibility Act. In addition, the bill would require expedited processing of any application involving the establishment of a foreign trade zone within a rural development investment zone, and would require Federal agencies to provide special assistance to rural development investment zones to the extent permitted by law.

Summary of H.R. 1747

Designation of enterprise zones

H.R. 1747 would authorize the Secretary of Housing and Urban Development to designate up to 12 Indian enterprise zones between 1992 and 1995. The designation of an area as an Indian enterprise zone generally would be effective for 25 years.

Tax incentives for Indian enterprise zones

The proposed tax incentives for Indian enterprise zones would include the following: (1) an employment tax credit generally equal to 10 percent of wages and health insurance costs; (2) a capital gains deferral of up to 10 years for amounts reinvested in Indian enterprise zone property; (3) a 25-percent tax credit for constructing child care facilities; and (4) a tax credit for a portion of the Federal income taxes attributable to income from Indian enterprise zone business. The bill would limit the amount of annual tax incentives that would be available.

The bill would also permanently extend the authority to issue qualified small issue bonds for Indian enterprise zones.

Effective date:—The tax provisions generally would be effective on the date of enactment.

Other provisions

The bill would give preference to the establishment of foreign-trade zones within designated Indian enterprise zones. In addition, the bill would require the Secretary of the Treasury and the Comptroller General each to prepare a study on the overall impact of

the bill, and to submit their studies not later than July 1, 1995, to the House Committee on Ways and Means and the Senate Committee on Finance.

Summary of Issues Relating to Tax Incentives for Enterprise Zones

The effect of tax incentives on the location of investments

In theory, favorable tax treatment of investment and employment within a specified geographic area should induce more economic activity to be located within that area. Because there are no Federal programs offering tax incentives targeted at specific geographic areas (other than Puerto Rico and other U.S. possessions), existing analysis has attempted to examine the effects of State and local financial incentives on location decisions. Econometric evidence on the effects of such programs on location decisions is inconclusive.

Surveys of business managers usually conclude that tax and other financial inducements are of secondary importance to a firm's location decision. However, many economists suggest caution in interpreting the findings of survey research because responses to survey questions may not accurately forecast the economic behavior of decision makers.

Some case study analyses of business location decisions have concluded that financial incentives are relatively important to the decision. Others have concluded that such incentives are relatively unimportant.

Efficiency and neutrality of tax incentives for enterprise zones

If investment in enterprise zones replaces investment that would have taken place elsewhere, the primary effect of the investment incentives would be redistributional. If the investment is redistributed from local labor markets with low unemployment to local labor markets with high unemployment, the incentives may generate efficiency gains for the economy as under-utilized resources are tapped.

Preferential tax treatment for certain investments or employment within enterprise zones creates economic inducements that may lead to an inefficient allocation of resources. Such efficiency losses must be weighed against the social goal of increasing economic growth and opportunity in distressed areas.

Incidence of enterprise zone benefits

The ultimate division of the tax benefits associated with enterprise zones among the potential beneficiaries depends on demand and supply conditions in the affected markets and the particular characteristics of the proposals. In general, the incidence of a tax (or subsidy) falls most heavily on the factor of production that is least mobile. Within an enterprise zone, land is an immobile factor and it may be expected that tax benefits granted for economic activity undertaken in an enterprise zone will tend to result in higher prices for land in the enterprise zone. Persons living within the enterprise zone or employed within the enterprise zone and entrepreneurs also may gain some of the tax benefits provided.

II. PRESENT LAW

Tax incentive provisions

Targeted geographic areas

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, targeted areas are defined under the qualified mortgage bond provisions of the Code as a means to promote housing development within economically distressed areas. Within these areas, which are defined on the basis of the income of area residents or the general economic conditions of the area, the rules for the financing of owner-occupied homes with qualified mortgage bonds are less restrictive than the generally applicable rules. Similarly, for purposes of the low-income housing credit, certain geographic areas are designated as high cost or difficult to develop areas. In these areas, the amount of the low-income housing credit is 130 percent of the amount that would otherwise be allowed.

In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States. Under these rules, a U.S. corporation that satisfies certain conditions may elect to eliminate U.S. tax (including the alternative minimum tax) on certain foreign source income that is related to the operation of a trade or business in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States. These special rules were enacted in order to encourage U.S. corporations to establish and maintain trades or businesses within these areas.

Tax credits for employers

Under present law, the income tax liability of an employer does not vary based on where an employee performs services on behalf of the employer. The targeted jobs tax credit under present law, however, provides a tax credit for a portion of the wages paid to individuals from nine targeted groups. These groups generally are defined according to the individual's physical condition, participation in a specified education or rehabilitation program, or economic status.

The credit generally is equal to 40 percent of the first $6,000 (or, in the case of a qualified summer youth employee, $3,000) of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit allowed with respect to any employee general-

ly is limited to $2,400. The employer's deduction for wages must be reduced by the amount of the credit claimed.[3]

Tax credits for employees

Under present law, the income tax liability of an employee does not vary based on where the employee performs services in the United States on behalf of an employer. However, an eligible individual who maintains a home for one or more qualifying children is allowed an advance refundable income tax credit based on the earned income of the individual and the number of qualifying children. For 1991, the earned income tax credit equals 16.7 percent (in the case of an individual with one qualifying child) or 17.3 percent (in the case of an individual with two or more qualifying children) of the first $7,140 of earned income.[4] For 1991, the credit begins to be phased out if adjusted gross income (or, if greater, earned income) exceeds $11,250 and is completely phased out if adjusted gross income (or, if greater, earned income) exceeds $21,240.

In addition to the regular earned income tax credit, present law provides for two supplemental credits: a supplemental young child credit for taxpayers with a qualifying child under the age of one (a 5-percent credit rate), and a supplemental health insurance credit for taxpayers who purchase insurance coverage for their qualifying children (a 6-percent credit rate). These supplemental credits are computed using the same earned income base (including phaseouts) as is the regular earned income tax credit.

Tax credits for investment

An income tax credit is allowed under present law for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings that were originally placed in service before 1936. The credit rate is 20 percent for expenditures incurred in rehabilitating certified historic structures and 10 percent for expenditures incurred in rehabilitating buildings originally placed in service before 1936. The basis of any building with respect to which the rehabilitation credit is claimed is reduced by the full amount of the credit.

Before 1986, a 10-percent investment tax credit was allowed for the cost of eligible tangible personal property that was used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit. The investment tax credit was not allowed with respect to real property.

Low-income housing tax credit

An income tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing. Both substantially rehabilitated existing housing and newly constructed housing are eligible for the credit. The credit percentage is adjusted monthly to maintain a present value of 70 percent for the costs of most new

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[3] Under present law, the targeted jobs tax credit is scheduled to expire on December 31, 1991. The President's fiscal year 1992 budget proposal would extend the credit for one year (i.e., the credit would expire on December 31, 1992).

[4] For 1994, these credit percentages are scheduled to be 23 percent for individuals with one qualifying child and 25 percent for individuals with two or more qualifying children.

construction and rehabilitation. The credit percentage (similarly adjusted) has a present value of 30 percent for the costs of acquiring existing property that is substantially rehabilitated and for creditable costs associated with property that receives other Federal subsidies (e.g., property that is financed with the proceeds of tax-exempt bonds).

Housing projects qualify for the credit only if one of two low-income tenant occupancy requirements is continuously satisfied for a period of 30 years (a 15-year compliance period followed by a 15-year extended use period). These restrictions require that (1) at least 20 percent of the housing units be occupied by individuals having incomes of 50 percent or less of the area median gross income or (2) at least 40 percent of the units be occupied by individuals having incomes of 60 percent or less of the area median gross income.

The basis on which the tax credit is claimed is equal to the "qualified basis" in the project, defined as the basis of the housing units actually occupied by low-income tenants plus an allocable share of the basis of common elements. No credit is allowed for the basis of (1) housing units occupied by nonqualifying tenants, (2) common elements allocable to such units, or (3) other facilities.[5]

Expensing of certain investments

There is no provision under present law that allows the amount of an investment to be expensed (i.e., deducted for the year in which the investment occurs) based on the location of the investment. Present law, however, provides that in lieu of a depreciation deduction, a taxpayer (other than an estate or trust) may elect to deduct all or a portion of the cost of qualifying property for the taxable year in which the property is placed in service. The maximum amount that may be expensed under this provision for any taxable year is $10,000. In general, qualifying property is any tangible personal property that is predominantly used in the active conduct of a trade or business.

Depreciation deductions

The depreciation deduction for any tangible property used in a trade or business or for the production of income is determined under the accelerated cost recovery system as modified by the Tax Reform Act of 1986. Under this system, the depreciation deduction for nonresidential real property generally is determined by using the straight line method and a recovery period of 31.5 years and the depreciation deduction for residential real property generally is determined by using the straight line method and a recovery period of 27.5 years. The depreciation deduction for tangible personal property generally is determined by using a recovery period that is based on the class life of the property and the 200-percent (or 150-percent) declining balance method (with a switch to the straight line method for the taxable year that the straight line method yields a higher depreciation deduction).

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[5] Under present law, the low-income housing tax credit is scheduled to expire on December 31, 1991. The President's fiscal year 1992 budget proposal would extend the credit for one year (i.e., the credit would expire on December 31, 1992).

Nonrecognition provisions

A sale or exchange of an asset generally is a taxable event. In a number of instances, however, gain or loss realized by a taxpayer upon the sale or exchange of an asset is not recognized for Federal income tax purposes. For example, no gain or loss is recognized if property held for productive use in a taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that also is to be held for productive use in a trade or business or for investment. As another example, a taxpayer generally may defer recognition of gain on the sale of a principal residence if the sales price of the old residence is reinvested in a new principal residence within a specified period of time. Present law does not provide for nonrecognition of gain or loss in the case of the sale or exchange of an asset solely because the asset is located within a particular economically distressed area.

Capital gains

Net capital gains are taxed as ordinary income under present law, subject to a maximum marginal rate of 28 percent in the case of individuals. In general, a capital asset is any property held by the taxpayer except certain specified types of property, such as inventory or property held primarily for sale to customers in the taxpayer's trade or business. Before 1987, net capital gains were taxed at a reduced rate. All taxpayers other than corporations could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20-percent tax rate on this income (40 percent of the gain included in income multiplied by a 50-percent maximum marginal income tax rate). The maximum tax rate for net capital gains of corporations was 28 percent. This reduction in tax was treated as a preference item for purposes of the minimum tax.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided. For example, interest on State or local government bonds generally is tax-exempt if the bonds are qualified small-issue bonds (used to finance manufacturing facilities or property acquired by first-time farmers) [6] or qualified redevelopment bonds. Tax-exempt private activity bonds issued by States and local governments generally are subject to State volume limitations. In addition, the depreciation deduction for property financed with tax-exempt bonds generally is determined by using the straight line method over the class life of the property.

Losses with respect to certain securities

The loss resulting from the worthlessness of a stock, bond, or other evidence of indebtedness issued by a corporation is generally treated as a loss from the sale or exchange of a capital asset. Consequently, the loss is subject to the general rules that limit the

[6] Under present law, the authority to issue qualified small-issue bonds is scheduled to expire on December 31, 1991.

amount of capital losses that may be allowed as a deduction for any taxable year.[7]

If an individual incurs a loss with respect to certain small business stock, the loss is treated as an ordinary loss rather than a capital loss. The maximum amount that may be treated as an ordinary loss for any year under this provision is limited to $50,000 ($100,000 in the case of spouses who file a joint return).

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until the time that the goods leave the foreign trade zone for shipment to other areas of the United States. The Foreign Trade Zone Board is responsible for approving applications for the establishment of foreign trade zones, while the Secretary of the Treasury is responsible for approving applications for the establishment of ports of entry.

Designation of enterprise zones under the Housing and Community Development Act of 1987

Pursuant to the Housing and Community Development Act of 1987, the Secretary of Housing and Urban Development (HUD) may designate not more than 100 nominated areas as enterprise zones (42 U.S.C sec. 11501 et. seq.).[8] An area may be so designated after being nominated by one or more local governments and the State or States in which it is located, and after the Secretary of HUD consults with (1) the Secretaries of Agriculture, Commerce, Labor, and the Treasury, (2) the Director of the Office of Management and Budget, (3) the Administrator of the Small Business Administration, and, (4) in the case of an area on an Indian reservation, the Secretary of Interior. An enterprise zone designation is to remain in effect for 24 years (or until an earlier termination date designated by the State or local government, or until the designation is revoked by the Secretary of HUD).

A nominated area may be designated as an enterprise zone only if it meets the following requirements: (1) the boundary of the area is continuous; (2) the area has a population of not less than 4,000 if any portion of the area (excluding certain qualifying rural areas) is located within a metropolitan statistical area with a population of 50,000 or more; and (3) the area's population is at least 1,000, or the area is entirely within an Indian reservation. In addition, the State and local governments (or Indian reservation governing body) must certify, and the Secretary of HUD must accept such certification, that (1) the area is one of pervasive poverty, unemployment, and general distress; (2) the area is located wholly within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; (3) the unemployment rate is at least 1.5 times the national

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[7] Generally, an individual may use no more than $3,000 per year in net capital losses to offset ordinary income. Unused net capital losses may be carried forward indefinitely.

[8] Prior to January 1, 1989, HUD received 270 nominations of areas seeking to be designated as enterprise zones. Thus far, no area has been designated as an enterprise zone.

unemployment rate; (4) the poverty rate within the area is at least 20 percent; and (5) either (a) at least 70 percent of the households in the area have incomes below 80 percent of the median income of households of the local government, or (b) the population of the area decreased by 20 percent or more between 1970 and 1980.

At least one-third of the enterprise zones must be within rural areas, meaning such areas (1) are within a local government jurisdiction(s) with a population of less than 50,000, (2) are outside of a metropolitan statistical area, or (3) are determined by the Secretary of HUD, after consultation with the Secretary of Commerce, to be rural areas.[9]

No area may be designated as an enterprise zone unless the local government and the State (or, in the case of a nominated area on an Indian reservation, the reservation governing body) in which the area is located agree in writing that, during any period during which the area is an enterprise zone, such governments will follow a specified course of action designed to reduce the various burdens borne by employers or employees in such area, including, but not limited to: (1) a reduction of tax rates or fees applying within the area; (2) an increase in the level of public services, or in the efficiency of the delivery of public services, within the area; (3) actions to reduce or simplify paperwork requirements within the area; (4) program involvement by public authorities, private entities, organizations, neighborhood associations and community groups, particularly those within the area (including a commitment to provide jobs and job training for, and technical, financial, and other assistance to, employers, employees and residents of the area); (5) providing special preference to contractors owned and operated by minorities; and (6) providing surplus land in the area to neighborhood organizations agreeing to operate a business on the land.

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[9] A rural area may be designated as an enterprise zone only if it is certified as being an area of pervasive poverty, unemployment, and general distress; but such a rural area need not satisfy all of the specific criteria which a non-rural area must satisfy to be designated an enterprise zone.

III. DESCRIPTION OF PROPOSALS

A. Description of H.R. 11 [10]

(Enterprise Zone Tax Incentives Act of 1991)

Designation of tax enterprise zones

In general

H.R. 11 would establish a demonstration program of providing incentives for the creation of tax enterprise zones in order to (1) revitalize economically and physically distressed areas, (2) promote meaningful employment for residents of tax enterprise zones, and (3) encourage individuals to reside in the tax enterprise zones in which they are employed. The bill would authorize the Secretary of HUD to designate 25 tax enterprise zones from areas nominated by State and local governments. The designations would be made during the calendar years 1992 through 1995 with no more than 10 designations in 1992 and no more than five designations in any other calendar year (unless, the number of designations in an earlier calendar year is less than the number of designations allowed for such calendar year). The designation of an area as a tax enterprise zone generally would be effective for 24 calendar years after the calendar year in which the area was originally designated as a tax enterprise zone.

Eligibility criteria

Under the bill, a nominated area other than a rural area generally would be eligible to be designated as a tax enterprise zone only if the area has: (1) a population of at least 4,000; (2) pervasive poverty, unemployment and general economic distress; (3) a size of no more than 12 square miles; (4) an unemployment rate of at least 1.5 times the national average; and (5) a poverty rate of at least 20 percent in at least 90 percent of the census tracts located in the nominated area.

A nominated area that is a rural area [11] would be eligible to be designated as a tax enterprise zone only if the area has: (1) a population of at least 4,000; (2) pervasive poverty, unemployment and general economic distress; and (3) a size of no more than 50 square miles in no more than four contiguous counties in the same State. In addition, a nominated rural area would be required to satisfy

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[10] H.R. 11 was introduced by Messrs. Rostenkowski, Rangel, Archer, Stark, Jacobs, Ford of Tennessee, Guarini, Matsui, Mrs. Kennelly, Messrs. Coyne, Andrews of Texas, Moody, Cardin, McDermott, Vander Jagt, McGrath, Sundquist, Dorgan, Mrs. Johnson of Connecticut, and others)

[11] For this purpose, a rural area would be defined as any area that is (1) outside a metropolitan statistical area as defined by the Secretary of Commerce, or (2) determined to be a rural area by the Secretary of Treasury, after consultation with the Secretary of Commerce and the Secretary of HUD.

two of the following four requirements: (1) an unemployment rate of at least 1.5 times the national average; (2) a poverty rate of at least 20 percent in at least 90 percent of the census tracts located in the area; (3) a decline in employment (as measured by decreased wages) of at least five percent over a five-year period; and (4) a decline in population of at least 10 percent between 1980 and 1990.

In addition, in order for any nominated area (including a rural area) to be eligible to be designated as a tax enterprise zone, the local government and the State in which the area is located would be required to agree in writing that they will follow a specified course of action that is designed to benefit employers and employees in the nominated area. A specified course of action would include tax benefits, financial incentives, or other assistance programs provided by the State and local governments to employers and employees in the nominated area.

Selection criteria

The bill would require the Secretary of HUD to designate tax enterprise zones from eligible nominated areas on the basis of the following criteria: (1) the strength and quality of promised contributions by State and local governments relative to the fiscal ability of these State and local governments; (2) the effectiveness and enforceability of the proposed course of action; (3) the level of commitment by private entities; (4) the degree of poverty and unemployment (and for rural areas, job loss and population loss) relative to other nominated areas; and (5) the potential for revitalization of the nominated area as a result of the designation of the area as a tax enterprise zone.

Tax incentives for tax enterprise zones

Employment tax credit

The bill would provide certain small employers with an enterprise zone employment credit equal to 10 percent of the sum of (1) the qualified zone wages paid or incurred during a taxable year and (2) the qualified zone employee health insurance costs paid or incurred during the taxable year. The amount of the enterprise zone employment credit of an employer for any taxable year, however, would be limited to the employment credit amount allocated to the employer for such year by the allocating official for the enterprise zone.

For purposes of the enterprise zone employment credit, qualified zone wages would be defined as wages that are paid or incurred by a small employer for services performed by a qualified zone employee. Qualified zone employee health insurance costs would be defined as amounts paid or incurred by a small employer for health insurance coverage of a qualified zone employee. A small employer would be defined as an employer that has an average number of employees for the taxable year that does not exceed 100.[12] A qualified zone employee would be defined for any period

[12] For this purpose, all employees of trades or businesses that are under common control are treated as employed by a single employer.

as an employee of a small employer if (1) substantially all of the services performed during the period by the employee for the employer are performed within a tax enterprise zone, and (2) the principal place of abode for such employee while performing the services is within the tax enterprise zone.

An employee would not be treated as a qualified zone employee for any period that occurs after the date that is five years after the day on which the employee first began work for the employer (whether or not in the tax enterprise zone). In addition, an employee would not be treated as a qualified zone employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to the employee during the year (whether or not for services rendered in a tax enterprise zone) exceeds $30,000 (or the equivalent amount if the employee is employed for only part of the year).[13] Further, an employee would not be treated as a qualified zone employee if for any taxable year the employee was treated by the employer as a member of a targeted group for purposes of the targeted jobs tax credit.

If the employment of any employee is terminated (other than voluntarily by the employee or due to the disability of, or misconduct by, the employee) within one year after the day on which the employee began work for an employer, then the amount of the enterprise zone employment credit previously claimed by the employer with respect to the employee would be recaptured by increasing the amount of tax due by the amount of the credit previously claimed with respect to the terminated employee.

The enterprise zone employment credit would be a general business credit and, as such, would be subject to the limitations on credit use that apply under present law (e.g., the credit would be nonrefundable and, if unused, would be carried back 3 taxable years and carried forward 15 taxable years). In addition, the amount of the deduction allowed an employer for wages or salary paid or incurred during a taxable year would be reduced by the amount of the enterprise zone employment credit for the taxable year.

Rehabilitation tax credit

In order for a building other than a certified historic structure to qualify for the rehabilitation credit under present law, the building must have been first placed in service before 1936. Under the bill, a building that is located in a tax enterprise zone on the date that the rehabilitation begins would qualify for the rehabilitation credit if there is a period of at least 30 years between the date that the building was first placed in service and the date that the rehabilitation begins. The amount of the credit allowable by reason of this special rule would be limited to the rehabilitation amount allocated to the building by the allocating official for the enterprise zone.

60-month amortization of child care facilities

The bill would allow the amortizable basis of a qualified child care facility to be recovered ratably over a 60-month period (begin-

[13] The $30,000 amount would be adjusted for increases in the cost of living occurring after 1991.

ning with the month that the facility is placed in service) in lieu of the depreciation deductions allowed under present law. For this purpose, a qualified child care facility would be defined as any facility that (1) is placed in service in a tax enterprise zone before the close of the 19th calendar year after the calendar year in which the zone was designated, (2) is primarily for use by the children of employees of the taxpayer who perform substantially all of their services for the taxpayer in the tax enterprise zone, and (3) complies with all applicable laws and regulations of a State or local government. In addition, the amortizable basis of a qualified child care facility would be limited to the child care amortization amount allocated to the facility by the allocating official for the enterprise zone.

Low-income housing tax credit for enterprise zone child care centers

For purposes of the low-income housing tax credit, the bill would increase the qualified basis of a qualified low-income building that is located in a tax enterprise zone by the amount of the eligible basis of the building that is used as a qualified child care center. A qualified child care center would be defined as any child care center that (1) provides care only for children who reside in the tax enterprise zone, (2) gives admission priority to children of residents of the qualified low-income building in which the center is located, and (3) complies with all applicable laws and regulations of a State or local government. This provision would apply only if the allocating official of the tax enterprise zone approves such treatment.

Capital gain deferral for reinvestment in zone property

The bill would allow individuals to defer the recognition of long-term capital gain from the sale or exchange of any property up to 9 taxable years after the taxable year in which the sale or exchange occurs if the amount realized from the sale or exchange is used to purchase qualified zone property within one year after the close of the taxable year of the sale or exchange. The amount of gain that qualifies for this special treatment would be limited to the capital gain deferral amount allocated to the taxpayer by the allocating official of the tax enterprise zone for the taxable year of the sale or exchange.[14] In addition, the amount of gain that qualifies for this special treatment over the life on any individual would be limited to $250,000.

For this purpose, qualified zone property would be defined as (1) any tangible property if substantially all of the use of such property occurs in a tax enterprise zone and in the active conduct of a trade or business by the taxpayer in the zone, and (2) any stock in a corporation or a partnership interest (other than an interest in a limited partnership) if two conditions are satisfied. First, at the time that the stock or partnership interest is issued, substantially all of the activities of the corporation or partnership must involve (or, in the case of a new corporation or partnership, will involve)

[14] The aggregate amount of capital gain deferral amounts allocated with respect to investments in any trade or business located in a tax enterprise zone generally would be limited to $5 million.

the active conduct of one or more trades or businesses in a tax enterprise zone. Second, the stock or partnership interest must be issued by the corporation or partnership for money or other property (other than stock or securities).

If a taxpayer disposes of qualified zone property (or the property otherwise ceases to be qualified zone property) before the date that is 5 years after the date that the property is purchased, then (1) the amount of gain that was deferred under this provision would be taken into account for the taxable year in which the disposition (or cessation) occurs, and (2) interest determined using the underpayment rate would be payable by the taxpayer on the amount of deferred tax for the period that the tax was deferred. For purposes of this recapture provision, any stock in a corporation or interest in a partnership would be treated as ceasing to be qualified zone property as of the close of any taxable year of the corporation or partnership unless at least 80 percent of the total gross income of the corporation or partnership for the taxable year was derived from the active conduct of a trade or business within a tax enterprise zone.[15]

Treatment of losses on investments in qualified zone corporations

The bill would treat any loss from the sale or exchange of a qualified zone corporate investment as an ordinary loss rather than a capital loss. For this purpose, a qualified zone corporate investment would be defined as stock or debt of a domestic corporation if (1) at the time of issuance, substantially all of the activities of the corporation involve (or, in the case of a new corporation, will involve) the active conduct of one or more trades or businesses in a tax enterprise zone, (2) the stock or debt was issued by such corporation for money or other property (other than stock or securities), and (3) during the most recent 5 taxable years of the corporation before the loss with respect to the stock or securities was sustained, at least 80 percent of the total gross income of the corporation was derived from the active conduct of a trade or business within a tax enterprise zone. In addition, a qualified zone corporate investment would not include any stock or debt if the adjusted basis of the stock or debt exceeds the special loss treatment amount allocated to the taxpayer by the allocating official of the enterprise zone.

Limitation on tax incentives

The bill would impose a limit on the amount of tax incentives that are available in each tax enterprise zone for each calendar year. The limit generally would equal $10 million plus an amount allocated to each tax enterprise zone based on the population of the zone as a percent of the total population of all tax enterprise zones designated during the same calendar year. The total amount to be allocated based on population to all of the tax enterprise zones designated during a calendar year would be $50 million, assuming five tax enterprise zones are designated during the year.[16]

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[15] This rule would not apply for the first taxable year of a new corporation or partnership.

[16] For tax enterprise zones designated during the 1992 calendar year, the total amount to be allocated based on population would be $100 million if all 10 zones that are allowed to be desig-

Continued

The limit on the amount of tax incentives for a tax enterprise zone would be increased by the amount of qualified State and local government expenditures and State and local business incentives provided with respect to the zone for the preceding calendar year. In no event, however, would the overall limit on the amount of tax incentives for a tax enterprise zone exceed 110 percent of the limit before taking into account the increase in the limit due to State and local government expenditures and business incentives.

The local governments and the State in which a tax enterprise zone is located would be required to designate a government official who is to be responsible for allocating the tax incentives of the zone among taxpayers and for ensuring that the annual limit on the amount of tax incentives of the zone is not exceeded. Each tax incentive provided by the bill (other than the special rule that applies to child care centers for purposes of the low-income housing credit) would be taken into account in determining whether the limit has been exceeded for any calendar year as follows: (1) 66 cents for each dollar of employment credit amounts allocated to taxable years beginning during the calendar year; (2) 85 cents for each dollar of rehabilitation credit amounts allocated to buildings with respect to which rehabilitation begins during the calendar year; (3) 3.27 cents for each dollar of child care amortization amounts for the calendar year that the property is placed in service and for each of the four succeeding calendar years; (4) 17 cents for each dollar of capital gain deferral amounts allocated to taxable years beginning during the calendar year; and (5) 1.5 cents for each dollar of special loss treatment amounts for the calendar year that the property is acquired and for each of the five succeeding calendar years.

Alternative minimum tax

Under the bill, enterprise zone tax incentives would not apply for purposes of the alternative minimum tax.

Effective date

The tax provisions generally would be effective on the date of enactment.

Other provisions

Preference in establishment of foreign trade zones

The bill would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in a tax enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in a tax enterprise zone. In evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with tax enterprise

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nated are actually designated. If the number of tax enterprise zones actually designated is less than the amount allowed, the $50 million and $100 million amounts would be proportionately reduced.

zones, the Foreign Trade Zone Board and the Secretary of the Treasury would be required to approve the applications to the maximum extent practicable, consistent with their respective statutory responsibilities.

Studies

The bill would require the Secretary of the Treasury and the Comptroller General to conduct separate studies on the effectiveness of the incentives provided by the bill in achieving the purposes of the bill. A report of each study would be required to be submitted not later than July 1, 1995, to the House Committee on Ways and Means and the Senate Committee on Finance.

B. Description of H.R. 23 [17]

(Enterprise Zone Jobs-Creation Act of 1991)

Designation of enterprise zones

Under H.R. 23, up to 50 enterprise zones would be designated over a four-year period from areas nominated by State and local governments. The Secretary of HUD would begin to make the designations on the later of June 30, 1991, or four months after the date of enactment of the legislation. Not more than 15 designations would be made during the first 12 months, not more than 30 within 24 months, not more than 45 within 36 months and not more than 50 within 48 months.

Under the bill, a nominated area other than a rural area would be eligible to be designated as an enterprise zone only if the area: (1) has a continuous boundary with a population of at least 1,000 (4,000 for enterprise zones located within a metropolitan statistical area with a population of at least 50,000); (2) has pervasive poverty, unemployment and general distress; (3) is located within a jurisdiction that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; (4) has an unemployment rate of at least 1.5 times the national rate; (5) has a poverty rate of at least 20 percent for each populous census tract within the area; (6) has at least 70 percent of its households with incomes below 80 percent of the median income of households of the local government, or had a population decrease of at least 20 percent between 1970 and 1980.

A nominated area that is a rural area [18] would be eligible to be designated as an enterprise zone only if the area: (1) has a continuous boundary with a population of at least 1,000; [19] (2) has pervasive poverty, unemployment and general distress; (3) is located within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; and (4) meets at least one of the other criteria set forth above with respect to nonrural areas.

In addition, in order for any nominated area to be eligible to be designated as an enterprise zone, the local government and the State in which the area is located would be required to agree that they will follow a specified course of action that is designed to benefit the nominated area. A specified course of action would include tax benefits, financial incentives, or other assistance programs provided by the State and local governments to employers and employees in the nominated area.

Under the bill, at least one-third of the areas designated as enterprise zones would be required to be rural areas. In addition, the Secretary would be required to designate enterprise zones from eli-

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[17] H.R. 23 was introduced by Messrs. Rangel, Bartlett, Machtley and Mazzoli. H.R. 23 is substantially similar to the enterprise zone provision contained in the President's fiscal year 1992 budget proposal.

[18] A rural area would be defined as an area that is (1) within a local government jurisdiction with a population of less than 50,000, (2) outside of a metropolitan statistical area, or (3) determined by the Secretary of HUD (after consultation with the Secretary of Commerce) to be a rural area.

[19] There would be no population requirements if the zone is entirely within an Indian reservation.

gible nominated areas on the basis of the following selection criteria: (1) the strength and quality of promised contributions by State and local governments relative to their fiscal ability; (2) the effectiveness and enforceability of the course of action; (3) the level of commitment by private entities; (4) other factors, including relative distress; and (5) reasonable geographic distribution of enterprise zones.

In general, the designation of an area as an enterprise zone would remain in effect for 25 years unless the designation provides otherwise or the Secretary revokes the designation.

Tax incentives for enterprise zones

Refundable wage tax credit for low-income zone employees

The bill would provide a 5-percent refundable tax credit to enterprise zone employees for the first $10,500 of wages [20] paid to an employee. To qualify for the full credit, an employee must work in an enterprise zone for an enterprise zone business [21] and have total wages below $20,000. The maximum credit would be $525; the credit would be phased out between $20,000 and $25,000 of total wages. In addition, the credit would be reduced for individuals subject to the alternative minimum tax.

In general, a business would qualify as an enterprise zone business if: (1) at least 80 percent of its gross income is attributable to active business activities conducted within the zone; (2) less than 10 percent of its property is stocks, securities or property held for use by customers; (3) no more than an insubstantial portion of the property is collectibles, unless held for sale to customers; (4) substantially all the property is located within the zone; and (5) substantially all the employees work within the zone. Rental real estate located within an enterprise zone would be treated as an active business and could qualify as an enterprise zone business without regard to the 10-percent test described above.

Exclusion of enterprise zone capital gain

The bill would exclude from gross income certain long-term capital gain realized from the disposition of enterprise zone property. Enterprise zone property would be defined as real property and tangible personal property (other than financial property and collectibles) located in an enterprise zone and used in an enterprise zone business. To qualify for the exclusion, the property must have constituted enterprise zone property for at least two years prior to disposition.

Only those gains attributable to periods that the property was used in an enterprise zone business would be eligible for the exclusion.

The gain exclusion would not be a preference for purposes of the alternative minimum tax.

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[20] For these purposes, "wages" generally would have the same meaning as for FUTA purposes.

[21] An employee of the Federal Government or any State or local government would not qualify for the credit.

Deduction for purchases of enterprise zone stock

Under the bill, individuals could elect to deduct up to $50,000 per year of the purchase price of enterprise zone stock, subject to a $250,000 lifetime limitation. In order for stock to qualify as enterprise zone stock, the following requirements would have to be met: (1) the stock must be common stock; (2) the amount of proceeds must be used by the issuer within 12 months to acquire enterprise zone property; and (3) the issuer must be a subchapter C corporation (a) which does not have more than one class of stock, (b) which is engaged solely in the conduct of an enterprise zone business, (c) which does not own or lease more than $5 million of property, and (d) more than 20 percent of whose stock is owned by individuals, partnerships, estates or trusts. In addition, a corporation could not issue more than $5 million of enterprise zone stock.

If the stock is sold (or the stock or the corporation ceases to meet the qualifications discussed above), the gain (or the full deduction in the case of a disqualification) would be recaptured as ordinary income. In addition, if the stock is disposed of before being held for 5 years (or a disqualification occurs within 5 years of purchase of the enterprise zone stock), interest would be charged on the decrease in tax that resulted from the deduction. The deduction would be treated as a preference for purposes of the alternative minimum tax.

Effective date

The tax provisions would be effective for taxable years ending after December 31, 1990.

Regulatory flexibility

The bill would expand the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified enterprise zone business, any unit of government designating an area as an enterprise zone to the extent any regulatory rule would affect carrying out projects within the zone, and any not-for-profit enterprise operating within such a zone.

Establishment of foreign trade zones in enterprise zones

The bill would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in an enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in an enterprise zone. In evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with enterprise zones, the Foreign Trade Zone Board and the Secretary of the Treasury would be required to approve the applications, to the maximum extent practicable, consistent with their respective statutory responsibilities.

Repeal of Title VII of the Housing and Community Development Act of 1987

The bill would repeal Title VII of the Housing and Community Development Act of 1987, effective upon enactment.

C. Other Proposals

Among other proposals to promote the economic development of certain geographic areas, H.R. 1445 and H.R. 1747 have been introduced to provide tax incentives for economic activity within specified geographic areas.

1. Description of H.R. 1445 [22]

(Rural Development Investment Act of 1991)

Designation of rural development investment zones

Definition of zone

The bill would amend the Internal Revenue Code to provide criteria for the designation of rural development investment zones. A rural development investment zone would be any area which was nominated as such by one or more local governments [23] and the State [24] in which the zone was located, and which was approved by the Secretary of the Treasury after consultation with the Secretaries of Agriculture, Commerce, Labor, and the Administrator of the Small Business Administration.

Before designating any area as a rural development investment zone (and within four months of enactment of the bill), the Secretary would have to promulgate regulations, after consultation with the above Federal officials, describing (1) the nomination procedures, (2) the size and population characteristics of a rural development investment zone, and (3) the procedures for comparing nominated areas using the criteria specified below for evaluating commitments made by State and local governments.

The Secretary could designate rural development investment zones only during a 36-month period that would begin on the first day of the first month after the effective date of the regulations. No more than 100 rural development investment zones could be designated under this provision, and no more than 40 zones could be designated during the first 12-month period it was effective.

The Secretary could not designate an area as a rural development investment zone unless the local government and the State in which the nominated area was located had the authority to nominate, to make commitments with respect to the zone, and to assure that the commitments would be fulfilled. The Secretary also would have to determine that the information submitted with a nomination was reasonably accurate and that no portion of the nominated area was already included in a rural development investment zone.

Period designation in effect

Any rural development investment zone designation would remain in effect from the date of designation to the earliest of (1)

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[22] H.R. 1445 was introduced by Mr. Dorgan, Mr. Grandy, and others.

[23] The term local government would include any county, city, town, township, parish, village or other general purpose political subdivision of a State, and any combination of these subdivisions that was recognized by the Secretary of the Treasury.

[24] The term State would include Puerto Rico, the Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, the Marshall Islands, Micronesia, Palau, and any other possession of the United States.

December 31 of the twelfth year following the year of designation, (2) the date stipulated by the State and local governments in their nomination application, or (3) the date the zone designation was revoked by the Secretary. No designation would take effect until the relevant State or local government submitted to the Secretary an inventory of historic properties within the area. The Secretary, after consulting with the same Federal officials who would be required to be consulted in designating rural development investment zones, could revoke a zone designation if it is determined that the State or local government was not substantially complying with the required State or local government commitments (described below).

Area and eligibility requirements

The Secretary could designate an area nominated as a rural development investment zone, only if the area met requirements concerning size, population, area boundaries, unemployment, poverty and other signs of economic distress. A description of these requirements follows:

(1). The area would be required to be (a) within a local government jurisdiction or jurisdictions that are not central cities of a metropolitan statistical area and that have a population of less than 50,000, (b) outside of a metropolitan statistical area, or (c) determined by the Secretary (after consultation with the Secretary of Agriculture) to be rural.

(2). The area does not exceed 10,000 square miles, consists of areas within not more than four contiguous counties, consists of not more than three noncontiguous parcels, and is located entirely within one State.

(3). The most recent census would be required to show that the area's population was at least 1,000.

(4). The nominating governments would be required to certify that the area was one of pervasive poverty, unemployment and general distress. In addition, the area would be required to meet at least two of the following criteria: (a) the unemployment rate is at least 1.5 times the national unemployment rate, (b) the poverty rate is at least 20 percent for not less than 90 percent of the population census tracts, (c) the amount of wages attributable to employment in the area is not more than 95 percent of such wages during the fifth preceding calendar year, and (d) the population of the area decreased by at least 10 percent between 1980 and 1990.

Required State and local government commitments

No area could be designated as a rural development investment zone unless the local government and the State in which it was located agreed that, during any period that the area was a rural development investment zone, these governments would follow a specified course of action designed to reduce the various burdens borne by employers or employees in the area.

This course of action could be implemented by the State and local governments and private nongovernmental entities, and could be funded from the proceeds of any Federal program. The course of action could include, but would not be limited to: (1) a reduction of tax rates or fees applying within the rural development investment

zone; (2) an increase in the level or efficiency of local services within the rural development investment zone; (3) elimination, reduction, or simplification of governmental requirements applying within the zone; (4) program involvement by private entities, organizations, neighborhood associations and community groups, particularly those within the nominated area (including a commitment from these private entities to provide technical, financial or other assistance to, and jobs or job training for, employers, employees and residents of the area); and (5) mechanisms to increase the equity ownership of residents and employees within their rural development investment zone.

Priority of designation

The bill would provide criteria for the Secretary to use in choosing areas to be rural development investment zones. The Secretary would be required to give special preference to those nominated areas for which the strongest and highest quality contributions to a course of action (as described above) had been promised by the nominating governments, taking into account their fiscal ability to provide tax relief. The Secretary also would be required to give preference to nominated areas with the following characteristics: (1) most effective and enforceable guarantees provided by nominating State and local governments that proposed courses of action actually would be carried out for the duration of the designation; (2) high levels of poverty, unemployment and general distress, particularly areas near concentrations of disadvantaged workers or long-term unemployed individuals for whom employment would be a strong likelihood if the area were designated a rural development investment zone, (3) zone size and location that would primarily stimulate new economic activity and minimize unnecessary Federal tax losses; (4) most substantial commitments by private entities of additional resources and contributions, including creation of new or expanded business activities; and (5) nominated zones which best exhibit such other factors that would be consistent with the program's intent and would be important in minimizing unnecessary loss of Federal tax revenues.

Evaluation and reporting requirements

The Secretary would be required to prepare and submit to Congress a report on the effects of designating qualifying areas as rural development investment zones in accomplishing the purposes of the legislation not later than the close of the third calendar year after the year in which areas are first designated as rural development investment zones. Subsequent reports would be submitted at three-year intervals.

Interaction with other Federal programs

Any reduction of taxes under any required program of State and local commitment under the bill would be disregarded in determining the eligibility of a State or local government for, or the amount or extent of, any assistance or benefits under any Federal law. In addition, the designation of a rural development investment zone would not constitute approval of a Federal program for purposes of the Uniform Relocation Assistance and Real Property Acquisition

Policies Act of 1970 or entitle any person displaced from real property in such zone to any rights or benefits under such Act. Such a designation also would not constitute a Federal action for purposes of applying the requirements of the National Environmental Policy Act of 1969 or other provisions of the law relating to the protection of the environment.

Tax incentive provisions

Wage tax credit

The bill would provide a 10-percent tax credit for employers in designated rural development investment zones for certain wages paid to qualified employees. Only the amount of qualified wages paid by an employer in designated rural development investment zones during a taxable year which exceeds the qualified wages paid during the 12-month period that preceded the date on which the rural development investment zone was designated would qualify for the credit. In no event, however, would qualified wages with respect to a qualified employee exceed an amount equal to 2.5 times the amount of wages subject to Federal unemployment (FUTA) tax (currently $7,000). Qualified wages for purposes of this credit generally would constitute the definition of wages currently applicable for FUTA tax purposes, with certain adjustments. One such modification would be the exclusion from the wage base of any Federally funded payments the employer received or accrued for on-the-job training. Special rules also would be provided for agricultural and railway labor.

For purposes of the credit, an individual would be required to satisfy a two-part test to become a qualified employee. The first part of the test would require that at least 90 percent of the services of the employee during the taxable year be directly related to the conduct of the employer's trade or business which was located in the rural development investment zone. The second part of the test would require that the employee perform at least 50 percent of the services during the taxable year in the rural development investment zone.

The rate of credit would be reduced from 10 percent to 7.5 percent beginning in the taxable year which includes the date which is 21 years after the area was designated as a rural development investment zone.[25] The rate of credit would be further reduced to 5 percent in the first succeeding year, 2.5 percent in the second year, and zero thereafter. If the Secretary revokes a rural development investment zone's designation, employers may continue to claim the wage credit for the three years subsequent to revocation but at rates of 7.5 percent, 5 percent, and 2.5 percent.

Investment tax credit

The bill would provide a 10-percent credit for the taxpayer's basis in new rural development investment zone construction property placed in service during a taxable year in which the zone is so

[25] This appears to be a drafting error, since zone designations would remain in effect for up to 12 years. The intent appears to be that the rate of credit would be phased down during the last four years before an area ceases to be a rural development investment zone.

designated. New rural development investment zone construction property consists of depreciable real property located in a rural development investment zone and used by the taxpayer predominantly in the active conduct of a trade or business within the zone. If acquired by the taxpayer, the first use of the property must commence with the taxpayer. Otherwise the construction, reconstruction, or rehabilitation of the property by the taxpayer must be completed during the period of zone designation. For purposes of this credit, the ownership of rental real estate would constitute an active trade or business.

As with the wage tax credit, the rate of credit would be reduced from 10 percent to 7.5 percent (and further reduced to 5 percent and 2.5 percent) during the last several years that designation of an area as a rural development investment zone remains in effect.

Effective date

The wage tax credit would be effective for taxable years beginning after December 31, 1990. The investment tax credit would apply to periods after December 31, 1990, under rules similar to prior law section 48(m).

Other provisions

Regulatory flexibility

The bill would expand the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified rural development investment zone business, any government designating an area as an rural development investment zone to the extent any regulatory rule would affect carrying out projects within the zone, and any not-for-profit enterprise operating within such a zone.

Establishment of foreign trade zones in development investment zones

The bill would require the Foreign Trade Zone Board to expedite on a priority basis the processing and approval of any application involving the establishment of a foreign trade zone within a rural development investment zone. The Treasury Department would be required to give the same urgent consideration to an application for establishment of a port of entry (necessary to permit the establishment of a foreign trade zone within a rural development investment zone). The bill would direct the Foreign Trade Zone Board and Treasury, in evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with rural development investment zones, to approve the applications to the maximum extent practicable consistent with their respective statutory responsibilities.

Responsibilities of Federal agencies

The bill would require Federal agencies to provide special assistance to rural development investment zones to the extent permitted by law. Such assistance could include (but would not be limited to) expedited processing, priority funding, program set-asides, and the provision of technical assistance. The heads of Federal agencies

would be directed to prescribe such regulations as might be necessary or appropriate to carry out the bill's purposes.

2. Description of H.R. 1747 [26]

(Indian Economic Development Act of 1991)

Designation of enterprise zones

The bill would provide tax incentives under a demonstration program for the creation of enterprise zones on Indian reservations. After nomination by tribal governments, the Secretary of HUD would designate 12 Indian enterprise zones between 1992 and 1995, subject to the availability of eligible nominated areas. In general, the designation would remain in effect for 25 years unless the designation provides otherwise or the Secretary revokes the designation for due cause. To be eligible, a nominated area must satisfy certain criteria, including population, geographic size, unemployment rate and poverty rate. The Secretary would choose among nominated areas on the basis of specific selection criteria including: (1) the willingness of the tribal government to make efforts to attract business to the zone; (2) the level of private enterprise commitment; (3) the effectiveness and enforceability of tribal commitments; and (4) the economic and social conditions and potential for the nominated zone.

Indian enterprise zone tax incentives

The proposed tax incentives for Indian enterprise zones generally would include the following: (1) an employment tax credit equal to 10 percent of wages and health insurance costs (25 percent if the employer has an Indian work force of 60 percent or more); (2) a capital gains deferral of up to 10 years for amounts reinvested in Indian enterprise zone property; (3) a 25-percent tax credit not to exceed $100,000 annually for taxpayer expenditures used to acquire, construct, or rehabilitate Indian enterprise zone child care facilities; and (4) a tax credit for a portion of the Federal income tax attributable to the income from conducting an Indian enterprise zone business. The bill would limit the amount of tax incentives that would be available in each enterprise zone for each calendar year. The tax incentives would be subject to allocation by a designated zone allocation official.

The bill would permanently extend the authority to issue qualified small issue bonds for Indian enterprise zones.

Effective date.—The tax provisions generally would be effective on the date of enactment.

Other provisions

The bill would give preference to the establishment of foreign-trade zones within designated Indian enterprise zones. Further, the bill would require the Secretary of the Treasury and the Comptroller General to prepare a study to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance not later than July 1, 1995, on the overall impact of the bill.

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[26] H.R. 1747 was introduced by Mr. Rhodes.

IV. ISSUES RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES

A. Overview of Issues

As a geographic matter, economic growth and development have not occurred evenly across the United States. While differences in resources and climates may explain part of the geographic diversity, within States and cities the pattern of economic growth is uneven. Some areas have high unemployment and decaying structures, while nearby areas enjoy full employment and prosperity. Some analysts have argued that this uneven pattern of growth is evidence of a failure of the market and that government intervention may be appropriate to encourage a more geographically even pattern of growth. In addition, other analysts observe that areas of high unemployment and blight often have higher crime rates, poorer health of the residents, and other social ills. They note these problems represent additional costs to society at large and that efforts to aid economic development in such areas would improve social welfare beyond that which would be measured by job creation, wages, or output.

Enterprise zone tax incentives are intended to encourage economic activity within a particular geographic location. All tax enterprise zone proposals provide tax incentives for the location of certain activities within certain economically distressed areas.[27] The proposals differ with respect to economic activities that are provided tax incentives and the manner in which the incentives are provided. For example, enterprise zone proposals may provide incentives for certain types of employment through an employer or an employee wage credit, or for certain types of capital through accelerated capital recovery methods or capital gains tax relief. In addition, the proposals often target relief to small businesses. Therefore, not only do tax enterprise zone proposals target tax incentives to particular geographic locations, but also within each enterprise zone the proposals target tax incentives to particular types of activities.

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[27] In many respects, the tax treatment of certain businesses located in U.S. possessions is analogous to tax provisions of enterprise zone proposals. The Puerto Rico and possessions tax credit shelters from U.S. income tax business income and qualified passive investment income earned by certain U.S. corporations operating in U.S. possessions ("section 936 corporations"). Almost all section 936 corporations operate in Puerto Rico. The Finance Committee Report accompanying the 1976 Tax Reform Act states that the purpose for the special tax of possession-source income is "[to] assist the U.S. possessions in obtaining employment producing investment by U.S. corporations." Therefore, like enterprise zone proposals, section 936 provides tax incentives for the location of economic activities within a limited geographic area exhibiting economic distress.

The effect of tax incentives on the location of investments

Enterprise zone proposals contemplate that economic incentives provided through Federal income tax relief can redirect investment toward economically disadvantaged areas. In theory, the provision of financial incentives should be able to induce economic activity to be located in designated areas. However, empirical research is inconclusive and, in any event, even if investment is redirected, cost benefit analysis might show that society does not benefit from the relocation of investment. As there are few Federal programs that provide economic incentives to redirect investment geographically, existing studies are based on State and local initiatives. The State and local initiatives may not be relevant to analysis of a Federal program, if it is contemplated that the Federal program will offer larger economic incentives than do existing State and local initiatives.

Research on the impact of State and local tax factors on the location decisions of firms is inconclusive. On the one hand, lower local property taxes or lower State or local income taxes act directly to lower the cost of doing business in a particular area. This could make low tax jurisdictions relatively attractive to businesses. On the other hand, relatively high tax jurisdictions may provide higher quality public services and are often associated with highly educated and/or highly skilled local labor forces. These factors could offset the higher tax cost of doing business in a high tax jurisdiction. Separating these conflicting forces is a difficult task and conclusive econometric evidence has not yet been provided on this issue.[28]

The General Accounting Office (GAO) has attempted to measure empirically the employment changes resulting from the tax benefits provided under one State's enterprise zone program.[29] The GAO measured monthly employment changes in three enterprise zones over a four-year period and concluded that while increases in employment did occur, "factors other than the [enterprise zone] program seemed to account for these increases." [30] The empirical analysis of the GAO study has been criticized.[31] For example, it is difficult to specify a correct counter-factual hypothesis of what employment levels would have been in the absence of the enterprise zone program. This makes it difficult to determine which, if any, changes in employment result from enterprise zone benefits. Also, four years may be too short a time period to assess the economic effect of an enterprise zone program.[32]

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[28] For examples on both sides of the issue, see "Why New Firms Locate Where They Do: An Econometric Model", by Dennis Carlton, in *Interregional Movements and Regional Growth* (William Wheaton, ed.), Urban Institute, 1979; and "Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know and How Do We Know It?", by Robert Newman and Dennis Sullivan, *Journal of Urban Economics*, March 1988.

[29] United States General Accounting Office, *Enterprise Zones: Lesson From the Maryland Experience*, GAO/PEMD-89-2, December 1988.

[30] *Ibid.*, p. 4.

[31] Jerry Wade, "The Maryland Enterprise Zone Program: A Progress Report and Response to GAO," Maryland Department of Economic and Employment Development, April 17, 1989.

[32] *See*, Edward V. Regan, "Report of Examination: Economic Development Zone Program," State of New York, Office of the State Comptroller, September 1, 1990. The report concluded that it was not possible to evaluate the effectiveness of an enterprise zone program initiated in 1986 without allowing several more years to pass.

As an alternative to empirical studies, a number of surveys have been undertaken to address the effectiveness of tax incentives on location decisions. Many economists suggest caution in interpreting the findings of survey research since responses to survey questions may not accurately forecast the economic behavior of decision makers. Nor may survey results based on State and local programs be applicable to a Federal program if the Federal program offers larger financial incentives. Nevertheless, surveys may provide some insight into the motivation of business managers who make decisions concerning location of investment. Generally, these surveys explicitly ask managers of firms about the importance of financial factors on location decisions. For the most part, these surveys have found that governmentally provided financial incentives (e.g., low interest loans, property tax abatements, income tax credits) are of secondary importance to a firm's location decision. Primary factors for location decisions have included items such as proximity to markets, availability of suitable raw materials, an appropriately trained labor force, and access to transportation networks. For example, the GAO surveyed employers in two of the enterprise zones in its study. The GAO reported that 60 percent of respondents rated financial incentives, including grants, subsidized interest rates, and other subsidies as of little or no importance to their location decision, while market access, community characteristics (community service, crime rate, etc.), and site characteristics each were listed as important by more than half the respondents.[33] Researchers hypothesize that the primary factors, such as proximity to markets, attract a firm to a particular geographic region and that the secondary factors, such as financial incentives, may affect the particular choice of location within that region.[34]

A third approach to determining the effect of tax incentives on the location of investments is the case study method. While case studies are, by nature, anecdotal they may reveal general trends. One case study has argued that the economic benefits of enterprise zones are important to firm location decisions. A study of Maryland's enterprise zone program cites financial incentives as important to Tandy Corporation's decision to locate a distribution center in Hagerstown, Maryland.[35] On the other hand, a case study of the General Motors' Saturn plant location decision concluded that tax incentives were a minor consideration in General Motors' final decision to locate in Spring Hill, Tennessee. Spring Hill's central location and proximity to transportation and cost reducing interstate highways were the primary considerations.[36]

Efficiency of tax incentives for enterprise zones

Even if tax incentives can significantly affect the location decisions of firms, it is unclear whether the induced investment in en-

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[33] GAO, *Enterprise Zones, op cit.*

[34] Other examples of survey research in this area include Michael Wasylenko, "The Location of Firms: The Role of Taxes and Fiscal Incentives", in Roy Bahl (ed.), *Urban Government Finance: Emerging Trends* Sage Publications, 1981; and Larry Ledebur and William Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in Steven Gold (ed.), *Reforming State Tax Systems*, National Conference of State Legislatures, 1986.

[35] Wade, "The Maryland Enterprise Zone Program," *op cit.*

[36] Andrew Kolesar, "Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development," *Tax Lawyer*, vol. 44, Fall 1990.

terprise zones constitutes net new investment or whether it is merely investment shifted from another locale. If investment in enterprise zones replaces investment that would have taken place elsewhere (for instance, if investment moves away from established centers of economic activity and toward designated enterprise zones), the primary effect of the investment incentives would be redistributional. To the extent that investment in enterprise zones is investment which is redistributed from local labor markets with low unemployment to local labor markets with high unemployment, the enterprise zone programs may direct investment from expensive local labor markets to those with an excess of relatively less expensive, under-utilized labor. In this event, the enterprise zone programs may generate efficiency gains for the economy as under-utilized resources are tapped. Efficiency gains also may result if reductions in unemployment lead to reductions in social ills such as crime, which some analysts view to be an externality associated with unemployment and blight.

In addition to providing incentives to locate existing businesses in particular geographical areas, the incentives could induce the creation of new businesses which would not otherwise have been initiated in any location. Such new businesses could produce taxable profits and incomes which might reduce the revenue cost of the incentives. On the other hand, the incentives could induce investments into enterprise zones which would be uneconomic in the absence of the tax incentives. Such an outcome would reduce the efficiency of aggregate national investment.

Competition between communities for the location of business may reduce the efficiency of tax incentives and other inducements. Thus, even if enterprise zones provide sufficient incentives to affect the location decisions of firms, an additional question is whether these incentives are cost-effective. To be cost-effective, the tax subsidies should be the smallest subsidies needed to achieve the desired behavioral change. Moreover, the subsidies should be narrowly targeted so that the benefits go primarily to firms that change their economic behavior in the desired fashion. That is, a cost-effective tax incentive program would minimize the amount of subsidy going to investors who would have located in the enterprise zone even in the absence of the tax subsidy program. When communities compete with one another using financial incentives, the chosen community may spend, in tax and other benefits, more than is necessary to induce the business to locate in a particular location.[37]

Tax incentives and the type of business formation

The choice of tax incentives granted to enterprise zone businesses may influence the type of business that will take place in an enterprise zone. For example, tax incentives for investment may induce more capital intensive businesses to locate in enterprise zones. Alternatively, if only employment credits are offered, more

[37] Kolesar, "Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development," *op cit.* Kolesar reports that before deciding to locate its new plant in Georgetown, Kentucky, Toyota, which had given early indication of preferring the Georgetown location, threatened Kentucky with the prospect of locating in another State. This strategy resulted in greater public assistance for Toyota than Kentucky had initially offered.

labor intensive businesses may be expected to locate in enterprise zones. Size limitations may induce small rather than large businesses to locate in enterprise zones. When a number of tax incentives are offered, the relative value of the different preferences may influence the type of businesses which locate within an enterprise zone.

Some argue that the need for enterprise zones grows out of the persistence of areas of pervasive unemployment and poverty, and therefore it is more appropriate to induce labor intensive businesses to locate in enterprise zones. It is argued that the resulting demand for labor simultaneously will attack both unemployment and poverty. Critics of this view note that there are no guarantees that the jobs created will be filled by residents of the enterprise zone. When jobs are filled by individuals from outside the enterprise zone, the objectives of reducing poverty and unemployment within the enterprise zone are not accomplished. Critics also observe that many labor intensive businesses are low wage employers which, by the nature of their business, offer little training to enhance the skills of employees. As a result, while employment might increase, poverty may only be somewhat mitigated and individuals' further economic advancement still is limited by a lack of marketable skills. Proponents counter that society gains by reducing government welfare payments and individuals gain by establishing positive employment histories.

Others argue that it may be more appropriate to induce capital intensive businesses to locate within enterprise zones. Capital intensive businesses often require skilled workers and pay higher wages. Proponents also argue that businesses which make large investments are less likely to move once available subsidies expire or when another community offers financial inducements. As a consequence, such businesses may provide a more stable base to area development. Critics of this view observe that the residents of many areas which might qualify as enterprise zones do not have the skills necessary to gain employment in many capital intensive businesses, and little employment gain among residents may result. They also note that often individuals do not choose to reside in close proximity to many capital intensive businesses and large capital intensive businesses may, by locating within an enterprise zone, displace current residents. Such displacement, if it occurs, may only disperse the problems of economic development which were manifest in the area's designation as an enterprise zone.

Some assert that only small businesses should be permitted to take advantage of the economic inducements offered within enterprise zones. They note that small businesses are responsible for many of the jobs created within the United States and that small businesses are often innovators. Critics of this view observe that small businesses fail frequently. Consequently, small business may provide an unstable employment base for an enterprise zone. They contend that large employers are more stable employers. They further note that many small businesses need large businesses to purchase their products and often find it most economical to locate near major customers. Proponents counter that fostering many small businesses rather than one or two large businesses creates a

broad economic base which is not subject to the business fluctuations of a single industry.

Others would like to encourage venture capital investments and the location of high technology businesses within enterprise zones. They contend that such businesses are the source of future economic growth and it is appropriate to direct some of this growth to economically under-developed areas. As discussed regarding capital intensive businesses above, high technology businesses may require skills not possessed by residents of an enterprise zone. Such businesses may find non-tax factors such as the proximity of scientists at a research university more important to their location decisions. Venture capital investments generally are high risk investments. Because a high risk implies a higher probability of failure, such investments may not provide stable employment opportunities within the enterprise zones.

Neutrality

Tax incentives for employment and investment in enterprise zones are intended to affect employment and investment decisions. However, these incentives can create an inefficient allocation of resources because the preferences can make it more profitable, on an after-tax basis, to locate property at site A rather than site B, even though on a pre-tax basis site B would produce greater pre-tax profits. On the other hand, the incentives may be necessary to promote the social goal of more economic growth and opportunity in distressed areas.

Targeting tax incentives within an enterprise zone can also reduce economic welfare below that which might be attainable under proposals with broad based incentives. For example, an employment tax credit may skew the allocation of resources within an enterprise zone to labor-intensive industries. Similarly, tax incentives for capital may skew the allocation of resources within an enterprise zone to capital-intensive industries. A proposal which provides incentives of similar magnitudes for all types of capital and all types of labor is likely to result in larger economic benefit per dollar of revenue cost than more narrowly targeted incentives.

Incidence of enterprise zone benefits

The tax benefits associated with enterprise zones are aimed at creating investment, employment, and business activity within the enterprise zones. However, as with any tax or subsidy, the ultimate division of these tax reductions among various classes of potential beneficiaries depends on demand and supply conditions in the affected markets and the particular characteristics of the proposals. In general, the incidence of a tax (or of a tax subsidy) falls most heavily on the factor of production that is least mobile, that is, the factor that is least able to escape the burden of the tax by changing behavior. Because enterprise zones distribute tax benefits according to geographic location, factors which are relatively immobile across geographic locations are more likely to receive the benefit of proposed tax incentives than are factors which are geographically mobile.

Among the groups that may benefit from the establishment of enterprise zones are those owning land in the zone, those who may

gain employment in the zone, those who invest in the zone, and the entrepreneurs who organize businesses with in the zone.[38] Land is an immobile factor. It may be expected that tax benefits granted for economic activity undertaken in enterprise zones will tend to result in higher prices for land in the enterprise zone. If other factors of production are to some extent immobile, some of the value of enterprise zone benefits may accrue to these factors. For example, if residents of other areas are unable to commute easily to jobs in enterprise zones, then residents of enterprise zones may accrue some of the benefits granted for employment or investment in enterprise zones.[39] Likewise, if entrepreneurs possess specific knowledge that aids in the establishment of a business in the enterprise zone, they may also gain some of the tax benefits provided.

Analysis of the incidence of enterprise zone tax benefits is further complicated by several factors. First, many of the potential employees of the newly established enterprises may be hired at wages at or near the minimum wage. Second, the proposals vary in the extent to which they provide incentives for employment as opposed to investment. Third, some proposals would place a limitation on the total tax benefits available within any particular zone.

A credit given to employers for wages paid for work within enterprise zones might well benefit minimum wage workers more than other workers hired. Businesses locating within enterprise zones might find it profitable to hire workers at the minimum wage whom they would not hire at the minimum wage were it not for the credit they receive. The individuals hired receive a portion of the benefit of the credit in the form of employment at a wage at least equal to the minimum wage. However, for workers paid above the minimum wage the credit may provide no benefit if the supply of such workers is great enough that businesses which may claim the credit can continue to hire these workers without having to bid up the wages they offer.

If, on the other hand, the credit were to be claimed by the employee, the business would not hire at the minimum wage an individual who is currently unemployed because the employer would be unable to pay the individual less than the minimum wage. Such an individual would receive no benefit from the tax credit. Those employed at wages above the minimum wage may now face competition from individuals willing to work at a lower wage with the knowledge that a tax credit will make up at least a part of the difference. If such competition among workers occurs, the employer benefits from lower labor costs. An employee who is currently employed at the minimum wage would, by law, face no direct competition and thus might benefit from the wage credit. However, the employer might find it profitable to substitute more skilled (and

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[38] The discussion above suggested that some of the potential benefit of tax subsidies provided in enterprise zones may be lost due to non-neutralities.

[39] Some analysts have suggested a spatial mismatch exists between employers and potential employees and that this has helped create pockets of unemployment in inner cities. However see, David Ellwood, "The Spatial Mismatch Hypothesis: Are There Teenage Jobs Missing in the Ghetto?" National Bureau of Economics Working Paper No. 1188, August 1983. In analyzing black, teenage unemployment, Ellwood finds no effect on the employment rate of teenage blacks of the proximity of job opportunities or of spatial neighborhood effects.

more highly paid) workers for such an employee, if the credit causes the wages paid to more skilled workers to fall.

One might expect tax benefits directed at investment rather than wages to benefit investors primarily. However, as with wage subsidies that might accrue to labor, the benefits of investment incentives will accrue to suppliers of capital only to the extent that capital is available in restricted supply to the enterprise zones. In a relatively competitive capital market, the benefits of investment incentives, like wage subsidies, will be shifted to other, less mobile factors, such as land. Hence, the incidence of the two types of subsidy need not differ markedly.

The degree to which tax benefits shifted from labor and capital are divided among land and entrepreneurs depends in part on the restrictions put on zone development through tax benefit limitations. If limitations are not imposed, activity may proceed to the point where entrepreneurs receive nothing more than a normal return to their efforts, with the entire benefit being received by land owners in the form of higher land rents or dissipated through the establishment of relatively high cost businesses. However, limitations may restrict the extent of this shifting, providing entrepreneurs with a greater fraction of the tax benefits that are provided.

Deferral v. exemption

Enterprise zone tax incentive proposals generally provide certain forms of income deferral from tax or exemption from tax. The form in which the incentive is provided affects the magnitude of the incentive. Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if $1,000 could be invested for 10 years to earn eight percent annually and those earnings were exempt from taxation, this investment would have accumulated $1,158.93 in interest by the end of the 10-year period. If the earnings instead were taxed annually to a taxpayer at a 28-percent marginal tax rate, the accumulated interest, net of taxes, would be $750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period, the value of the taxpayer's net earnings would be $834.43. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of tax-exempt income is greater for taxpayers in higher marginal tax rate brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is taxed at a high marginal rate, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is taxed at a low marginal rate and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually

be worth less than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Equity considerations

Horizontal equity requires that taxpayers in similar situations be treated by the tax system in the same manner. To the extent taxpayers with identical economic incomes bear different income tax burdens as a result of the enterprise zone tax incentive programs, horizontal equity is not attained. This may be more of a concern in the short run than in the long run because such differential tax treatment may be capitalized in the price of assets leading to an equalization of after-tax incomes.[40] Vertical equity requires that taxes be assessed in accordance with the taxpayer's ability to pay. To the extent that the benefits of enterprise zone tax incentives accrue primarily to high-income taxpayers, vertical equity may be compromised.

Tax incentives may be structured as either deductions or credits. When taxpayers face different marginal tax rates, deductions yield different dollar amounts of tax benefits depending upon the taxpayer's tax bracket. As the taxpayer's income and marginal tax rate increase the tax subsidy increases. Credits yield the same dollar amount of tax benefit to all recipients.[41]

Limitations on benefits

The primary goal of enterprise zones is to foster economic development within specified geographic areas. The tax benefits made available to enterprise zones may, however, be used to satisfy policy goals other than the economic development of the designated geographic area. For example, one may want to limit the ability of higher-income persons to utilize the tax benefits; to limit the magnitude of Federal assistance to any one geographic region; or to foster certain forms of economic development such as the creation of labor intensive businesses rather than capital intensive businesses. Limitations on tax benefits available in enterprise zones may be used to satisfy policy goals which are in addition to the goal of the economic development of the designated geographic area. Proponents of limitations on tax benefits believe it is appropriate to address these additional policy concerns within the context of geographic economic development programs. Opponents observe that imposing limitations on tax benefits may reduce the magnitude of the tax incentives for economic development and thereby make it more difficult to achieve desired levels of economic development.

Limitation of the tax benefits available in enterprise zones generally may take two forms: limitations on specific tax benefits and limitations on the aggregate level of benefits. In the former case, the amount of tax benefit available to any one taxpayer may be

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[40] For example, under present law the interest paid on State and local bonds generally is tax-exempt. However, the interest paid on such tax-exempt bonds is less than that paid on taxable bonds. For many taxpayers, after-tax income is approximately the same whether they purchase a taxable bond and pay tax or purchase a tax-exempt bond (with similar risk and maturity) and earn less explicit interest. To the extent that yield spreads do not completely reflect the effect of the tax, horizontal equity could be said to be violated.

[41] This is not strictly true if the taxpayer has an insufficient tax liability to utilize the credit and the credit is not refundable.

limited or the class of qualifying taxpayers may be limited, but there generally is no limitation on the number of qualifying taxpayers who may receive the tax benefit. Many such limitations exist under present law. For example, the amount of money a taxpayer may annually contribute to a qualified pension is limited, but there is no limitation on the number of taxpayers who can make qualifying contributions. Present law also provides limitations on the aggregate amount of tax benefits available in certain cases. For example, the low-income housing credit is subject to an annual State credit allocation ceiling.

If a limitation on the aggregate level of benefits is utilized, it is necessary to create a method of allocating the available benefits among potentially competing taxpayers. For example, under present law, allocations of the low-income housing credit are made by State allocating agencies. Critics of this approach argue that the market system is impeded by introducing a government agency into the process. They argue that market allocation decisions generally are superior to other outcomes and agency involvement slows individuals' ability to react to market opportunities. They note that the concept of an enterprise zone is based on a philosophy of non-planning and private sector domination.[42] Proponents note that utilizing an allocating agency has the potential advantage of bringing State and local officials into the economic development process as partners whose participation may enhance the possibility of success because these officials have a stake in the success of the project. They observe that these officials may better know the needs of their jurisdictions and may be able to allocate the Federal benefits, or to combine the Federal tax benefits with State and local benefits, to achieve the economic development goals of their jurisdictions at least total cost. They further observe that such officials may provide oversight of the program to the benefit of taxpayers generally.

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[42] Michael Allan Wolf, "Enterprise Zones: A Decade of Diversity," *Economic Development Quarterly*, vol. 4, February 1990.

B. Issues in the Design of Specific Enterprise Zone Tax Incentives

Tax credits for enterprise zone employment

The tax credits for enterprise zone employment in H.R. 11, H.R. 23, H.R. 1445, and H.R. 1747 consist of two separate types: a credit for increased employment and a credit for employee compensation. H.R. 1445 creates a credit for increased employment, while H.R. 11, H.R. 23, and H.R. 1747 create a credit for employee compensation. H.R. 11, H.R. 1445, and H.R. 1747 would provide the credit to the employer. H.R. 23 would provide the credit to the employee.

Tax credit for increased employment expenditures

H.R. 1445 would provide a 10-percent tax credit for increased employment expenditures. This credit is intended as an incentive for the expansion of employment and wages beyond a base period level of wage expenditures. Because only wages below the designated cap would be eligible for the credit, the credit would provide an incentive for part-time or modestly compensated labor. For example, if the wage cap were $17,000, an increase in wages paid from $17,000 to $18,000 for additional work performed by a current employee would not be eligible for the credit, but hiring a part-time employee to do the same work for $1,000 would generate wages eligible for the credit.

The employer credit for increased employment expenditures is a marginal credit which for existing employers is determined by reference to the amount of qualified wages paid by the employer prior to designation as an enterprise zone. If in later years the amount of employment and qualified wages decline from a previous higher level, the amount of wages paid in excess of the amount paid before the area was designated an enterprise zone would still qualify for the credit. In the case of a business that starts up after an area is designated as an enterprise zone, *all* qualified wages would be eligible for the credit *every* year.

Tax credit for compensation paid employees

H.R. 11 would provide a 10-percent tax credit to employers for wages and health insurance costs of qualifying employees. Qualifying employees must receive annual wages of less than $30,000, live in the enterprise zone, and work in the enterprise zone for an employer who does not employ more than 100 employees. H.R. 23 would provide a 5-percent credit to employees for the first $10,500 of wages (based on the FUTA wage base) to employees who work in an enterprise zone. The credit in H.R. 23 is phased out for wages between $20,000 and $25,000.

Some argue that such credits would have the greatest effect on the distressed area if the employee were required to live and to work in the enterprise zone. Others claim, however, that it is necessary to provide incentives for businesses to establish operations within a zone and encourage more employment within a zone because increased employment and business activity within a zone will benefit the distressed area regardless of where the employees reside. (A more general discussion of the incidence of the benefits of wage credits is presented in Part IV. A., above.)

Some question the need to provide a tax credit to individuals who would otherwise be well compensated and argue that it is prudent to reduce the credit amount for individuals with compensation above a certain level. Others maintain that new enterprise zone businesses require a mix of skill levels, and an incentive for individuals at all compensation levels is needed.

Investment tax credit

H.R. 1445 would provide a 10-percent credit for newly constructed depreciable real property located in enterprise zones. The credit, unlike the investment tax credit in the past, would be for depreciable real estate and not equipment. In the past, it has been argued that it was necessary to encourage investment in equipment, rather than real estate, as a means to encourage more productive business activities.

Supporters of such a tax credit observe that it would be necessary to build up the capital stock in enterprise zones, including the stock of housing. Depreciable real estate, because it is not movable, would have long-term benefits for the enterprise zone area that could not be provided by increased investment in movable equipment.

Treatment of capital gains and purchases of enterprise zone stock

In general

H.R. 11 and H.R. 23 would create preferential treatment for capital gains with respect to enterprise zone property. H.R. 11 would permit taxpayers to defer recognition of gain for up to ten years on any property sold if the proceeds were reinvested in enterprise zone property. H.R. 23 would exclude from taxable income any gain on qualifying enterprise zone property accrued during the period of enterprise zone designation.

In addition, H.R. 23 would create a deduction for the purchase of qualifying stock in a qualifying enterprise zone corporation. If the deduction were claimed, the taxpayer's basis in the stock would be reduced by the amount of deduction claimed, and any subsequent gain would be taxed as ordinary income. Such tax treatment is equivalent to exempting the gain on qualifying stock from tax. To illustrate, assume a taxpayer with a marginal tax rate of 28 percent purchases $1,000 of qualifying stock. The initial tax saving from deducting the cost of this stock is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the stock has appreciated at an annual rate of 10-percent and that the taxpayer sells the stock after one year.[43] The value of the stock upon sale will be $1,100 which must be included in income, creating a tax liability of $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 in the qualifying stock, the stock would have been worth $792 after one year (assuming the same 10-percent rate of return). Upon sale the taxpayer would have to pay tax of $20.16 (.28 times $72) on the capital gain of $72

[43] H.R. 23 charges interest if a disposition occurs within five years. For the purpose of the example, no holding period requirement is assumed.

and would be left with $771.84 after payment of taxes. The value of the deduction for the purchase of qualifying stock is that the taxpayer does not have to pay the $20.16 in tax on the capital gain. Thus, the deduction for the purchase of qualifying stock effectively allows the taxpayer to obtain a tax-free return on an investment of $720.

Alternatively, the deductibility of the purchase of qualifying stock can be viewed as an investment that is jointly owned by the government and the taxpayer. The government's ownership share is equal to the tax rate (28 percent in the above example). When the stock is sold, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free return on the investment.

The taxpayer receives an additional advantage if the taxpayer's marginal tax rate in the year the stock is sold is lower than the marginal tax rate in the year the stock is purchased. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the stock is sold, the lower the tax rate prevailing at that time, the smaller the government's share. On the other hand, the advantage of the deductibility of the purchase of qualifying stock is reduced if the taxpayer's marginal tax rate is higher at the time the stock is sold than at the time the stock is purchased.

Preferential treatment for capital gains realized outside an enterprise zone if the proceeds are invested in an enterprise zone may be expected to encourage an investor to roll over his or her equity into an enterprise zone investment. Limiting an investment incentive to the class of taxpayers with accrued capital gains rather than all potential investors may limit the effectiveness of the incentive in increasing total investment in an enterprise zone.

Incentives for equity investments

Preferential capital gains tax rates for enterprise zone property and deductions for purchases of enterprise zone stock are intended to encourage investors to buy corporate stock in enterprise zone businesses, and especially to provide venture capital for new companies, thereby stimulating investment in productive business activities within the zone. They note that investment is necessary to create jobs and growth.

Opponents of preferential capital gains treatment for zone assets generally make three arguments. First, such preferences may create windfalls for owners of existing enterprise zone property. Demand for such property is increased by a tax preference which is available only to property within a specified geographic location, thereby driving up its price. Opponents argue that such windfalls would do little to create new employment opportunities. Moreover, to the extent that housing, and more generally, land are qualifying assets, the increased demand for these assets could drive up the cost of housing in designated enterprise zones.

Second, a preferential tax rate for capital gains, even if targeted geographically, encourages taxpayers to enter into transactions designed to convert ordinary income into capital gains. Proponents

counter that such "conversion" opportunities are simply part of the overall tax incentive for investments in enterprise zones which the preference is intended to encourage. They further observe the Tax Reform Act of 1986 made several changes to limit conversion opportunities.

Third, preferential treatment of capital gains may be inefficient because the preference is available to investments which would have occurred without the preference as well as to net, new investments. Opponents also question the efficacy of a deduction for the purchase of stock in enterprise zone corporations. They note corporations routinely raise capital and that as a consequence the benefit of the deduction for purchases of corporate stock often may go to investors who would have purchased the stock without the deduction. Proponents of the deduction for the purchase of zone stock respond that even when this occurs the deduction will have encouraged equity investments rather than debt, and that greater equity participation will create a more stable business.

Cost of capital

Proponents of preferential treatment for capital gains for enterprise zone property and deductions for the purchase of stock in enterprise zone corporations argue that the cost of capital is high for enterprise zone investments. They argue that a preferential tax rate on capital gains increases investors' net returns on such assets and thereby will lower the cost of capital for such investments. In addition, proponents note, a deduction for the purchase of stock in an enterprise zone corporation makes such stock relatively more attractive than other assets and thereby lowers the cost of raising investment funds. With a relatively lower cost of capital, more investment capital would flow into designated areas.

Opponents argue that because the preference for capital gains accrues only to property located in the enterprise zone, gains in reduced capital costs may be offset by increases in land costs, as the demand for such land increases. In addition, opponents argue that because of the ability to defer gains, the ability of individual taxpayers to receive step-up of basis at death, and the substantial participation of tax-exempt institutions in the investment markets, the effective tax rate on gains, which helps determine the cost of capital, may already be substantially below the statutory rate. On the other hand, proponents of a capital gains tax reduction for enterprise zone property note that because nominal gains are taxed, that even accounting for deferral, the effective tax rate on real (inflation adjusted) gains can be high. They further contend that any reduction in a tax on capital reduces the cost of capital for these investments.

Incentives for risk-taking

Proponents of preferential treatment argue that a reduced tax rate on gains encourages risk-taking, and that investors generally would view investments in designated zones as particularly risky. As a consequence, a preferential capital gains tax rate for enterprise zone property is justified to overcome this outcome of the marketplace. In addition, it is argued, preferential treatment is important for the entrepreneur who often contributes more in time

and effort than in capital. However, the financial gains from risk-taking and the creative process are the major rewards entrepreneurs seek. Providing a tax benefit may inefficiently subsidize such activity beyond the socially optimal level.

Opponents of preferential treatment argue that if risk-taking is to be encouraged, a more efficient method might be to reduce the current asymmetric treatment of gains and losses, by expanding the provisions for loss offset in a targeted manner. However, preferred treatment for capital losses within enterprise zones may attract more risky investments to enterprise zones than throughout the economy at large. Because high risk implies a higher probability of failure, such investment may not provide stable employment opportunities within the enterprise zone.

Length of preference period

Choosing the length of time during which preferential treatment for capital gains is to apply involves trade-offs. The choice of preference period may affect the efficiency of the tax incentive as well as the ease or difficulty incurred by the taxpayer in complying with, and the Internal Revenue Service in administering, the provision.

Creating a permanent preference for capital gains which accrue on property in enterprise zones could bestow benefits on owners of assets long after the economic development of an enterprise zone has progressed to the point that such benefits are unnecessary. Permitting preferential treatment on gains accrued prior to enterprise zone designation may reduce taxes without generating commensurate employment or productivity growth in return. On the other hand, a permanent preference could be relatively simple to administer.

Proposals which would grant preferential capital gains treatment only during a limited period, such as during the period of enterprise zone designation, would create incentives to sell the enterprise zone property before the end of such period. This could reduce the attractiveness of enterprise zone investments, thereby reducing the effectiveness of the preference. The incentive to realize gain prior to the expiration of the period of preferential treatment could reduce prices for enterprise zone assets and create instability in the market for such assets. Some argue that a preference for a limited period does not promote investment with a long-term view, but rather creates a short-term, unstable investment environment. In addition, limiting the preference to gains which accrue during a specified period may require appraisals of enterprise zone assets at the beginning and end of the period. Such appraisals can be costly and create tax compliance difficulties.

Rehabilitation tax credit

H.R. 11 would extend the rehabilitation tax credit to qualified expenditures made with respect to buildings placed in service after December 31, 1935, if the building were located in an enterprise zone, as long as the building was first placed in service at least 30 years before the physical work on rehabilitation begins.

This provision is intended to encourage the rehabilitation of existing structures that meet the age requirement. Reducing the age

requirement for buildings in an enterprise zone makes rehabilitating a qualified building more attractive to taxpayers relative to the alternative of rehabilitating a building that does not meet the age requirement or constructing a new building. To the extent that the social value of rehabilitating a building (including the aesthetic value) is greater than the private value an investor places on the rehabilitation, a subsidy may be necessary to encourage the desired social behavior. One argument in favor of a higher social than private value of rehabilitation for existing buildings focuses on the positive impact that a newly rehabilitated building may have on the values of nearby buildings. This increase in the property values of other property is generally not part of the profit-or-loss calculation done by an investor who is deciding whether to rehabilitate an existing building.

It is often argued that buildings have deteriorated faster in areas of economic distress (perhaps due to urban blight or neglect). These areas are generally perceived as the sort that might be designated as enterprise zones. Accordingly, it may be appropriate to shorten the eligible age for the rehabilitation credit for buildings located in an enterprise zone.

To the extent the reduction in eligible age for buildings in an enterprise zone succeeds in generating rehabilitations of buildings that would otherwise be ineligible for the rehabilitation credit, other enterprise zone property may experience an increase in value. However, this beneficial effect comes at the expense of a market distortion in the pricing of real property, since rehabilitation of qualified property may not be the optimal choice from a social perspective (e.g., it might be more efficient to demolish existing buildings and construct new buildings to take advantage of new manufacturing technology). In addition, if taxpayers would have undertaken the rehabilitation of existing buildings in the absence of the expanded rehabilitation credit, then the proposal lowering the eligible age is an inefficient subsidy, since taxpayer behavior is not influenced by the credit.

60-month amortization of child care facilities

To encourage the provision of child care facilities by businesses located in enterprise zones, H.R. 11 would permit 60-month amortization of the adjusted basis in a qualified child care facility.[44] This provision permits faster recovery of the cost of these child care facilities than is available under ordinary depreciation. A taxpayer claiming the 60-month amortization foregoes the ordinary depreciation deductions associated with such property. Qualified expenditures subject to amortization include the adjusted basis of a child care facility located in an enterprise zone where the facility is used primarily by the children of employees of the taxpayer located in the enterprise zone.

The intent of this provision is to reduce the after-tax cost to taxpayers located in an enterprise zone who provide child care facilities for their employees. If firms can provide cost-effective on-site child care for their employees, it may increase the retention rate of

[44] The 60-month amortization period is the same period given to pollution control facilities placed in service prior to 1976.

the firm's employees, or permit the employer to provide tax-favored compensation to the employee in the form of subsidized child care. Both effects may provide enterprise zone employers with an advantage over competitors located elsewhere.

To the extent the 60-month amortization deductions exceed the economic depreciation (i.e., the decline in value) of the child care facility, there will be a tax-induced incentive to invest in child care facilities located in enterprise zones. This may not be the most effective use of the taxpayer's funds, in that profitable opportunities may be passed over and investment made in tax-favored child care facilities. Moreover, if taxpayers would ordinarily construct child care facilities on-site, then the tax subsidy through a relatively rapid amortization schedule may be inefficient, because it would have little effect on taxpayer behavior.

Low-income housing tax credit

H.R. 11 would permit the portion of a building used as a qualified child care center to be included in the qualified basis of the building for purposes of claiming the low-income housing credit. Therefore, the cost allocated to the child care facility would be eligible for the credit. For purposes of this provision, a qualified child care center is a facility that provides care only for children who live in the tax enterprise zone and that gives priority for admission to the children of residents of the qualified low-income building in which it is located.

The purpose of this provision is to encourage developers of low-income housing projects located in tax enterprise zones to provide on-site child care facilities. To the extent that private developers currently find it unprofitable to include child care facilities as part of a low-income housing development, this provision may provide the financial subsidy necessary to reverse this situation. On the other hand, the proposal allows the entire adjusted basis of the child care facility to be added to the qualified basis of the low-income housing project. This may provide developers with the incentive to overstate the costs attributable to the child care facility in order to maximize the size of the credit that may be claimed.

The requirement that a qualified child care facility provide care only to residents of the tax enterprise zone in which it is located is intended to benefit the residents of the enterprise zone, by preventing the child care facility from being used primarily by the children of employees who commute from other areas. To the extent that demand for child care among residents of the enterprise zone is insufficient to support child care facilities that can support economies of scale, this requirement may result in facilities that are not used in an efficient manner. Moreover, the proposal would subsidize only the capital costs of the child care facility, not the operating costs.

Private activity bonds

H.R. 1747 would provide for a permanent extension of the small-issue qualified bond sunset date of December 31, 1991, for bonds issued to finance investment in Indian enterprise zones. If investors could be certain that future investments in enterprise zone property could be financed in a tax-exempt manner, they might be more

likely to engage in a long-term planning process than if they believed such financing would be available only for a limited period. Presumably, having a long time horizon would contribute to the probability of success of firms locating in Indian enterprise zones. However, the provision of the implicit subsidy of tax-exempt finance for Indian enterprise zone investments could result in financial savings to firms that would have undertaken the investments even in the absence of such a capital subsidy. If this possibility were a major concern, then a temporary extension that would be reviewed periodically might be a more desirable alternative. Moreover, critics of tax-exempt finance view tax-exempt bonds as an inefficient capital subsidy. On the other hand, investments in Indian enterprise zones in the absence of tax-exempt finance might face a high cost of capital because of the perceived risk of such investments. Tax-exempt financing would lower the cost of capital for such investments.

Size of enterprise zones

An important consideration in designing a proposal intended to help spur development in economically depressed areas is the allowable size of an enterprise zone. To the extent the enterprise zone itself is geographically compact, the tax benefits provided may be more intensively targeted to a relatively small area. This may concentrate the impact of the valuable tax incentives provided through an enterprise zone program. Concentrating economic development may be a desirable strategy since the encouragement provided through an enterprise zone program may be greater than the sum of the various tax incentives provided, if neighboring businesses have beneficial effects on each other. Conversely, if the tax incentives provided through an enterprise zone program are geographically dispersed, the businesses involved may not be able to capture the operating economies that may exist when businesses are in close proximity.

It is possible that size constraints may operate to limit the types of areas that may qualify as enterprise zones. For example, rural or suburban areas tend to have low population density. In order to meet desired levels of economic development, public officials may believe that a minimum number of businesses must be affected. For the less densely populated areas of the United States, a tight size constraint for enterprise zones may preclude the possibility of these tax incentives affecting economic development to any significant extent.

To provide some perspective on the sizes of allowable enterprise zones under the legislative proposals under consideration, Table 1 lists the sizes of selected metropolitan areas. A 12 square mile enterprise zone is relatively large, compared to the size of many cities.[45] A 10,000 square mile enterprise zone is large compared to the size of some states (7 states have an area of less than 10,000 square miles, and 10,000 square miles is roughly the size of Maryland).

[45] For example, Jersey City, New Jersey has a land area of approximately 13 square miles.

Enterprise zone proposals generally have some allowance for non-contiguous areas to be aggregated into a single enterprise zone. The rationale for this feature is to permit public officials to combine economically disadvantaged areas that may not neighbor each other into a single enterprise zone in order to take advantage of economies of scale in administering an enterprise zone. However, one potential pitfall in the allowance of non-contiguous areas to be part of a single enterprise zone is that areas with significantly different demographic or economic characteristics may be combined into a single zone and treated in similar fashion. This concern could be addressed with a requirement that an enterprise zone have a continuous perimeter no longer that X miles. In such a way, both the concern over size of an enterprise zone and the concern over non-contiguous areas being incorrectly aggregated would be mitigated.

Table 1.—Land Area of Selected U.S. Cities

City	Area (sq. miles)	Population (1988 estimate)
Baltimore	80.3	751,000
Boston	47.2	578,000
Chicago	228.1	2,978,000
Cleveland	79.0	521,000
Dallas	333.0	987,000
Detroit	135.6	1,036,000
Honolulu	87.0	376,000
Indianapolis	351.9	727,000
Kansas City, MO	317.4	439,000
Las Vegas	79.2	211,000
Los Angeles	467.3	3,353,000
Memphis	264.1	645,000
Milwaukee	95.8	599,000
Minneapolis	55.1	345,000
New Orleans	199.4	532,000
New York	301.5	7,353,000
Oakland	53.9	357,000
Philadelphia	136.0	1,647,000
Pittsburgh	55.4	375,000
St. Louis	61.4	404,000
San Diego	328.6	1,070,000
San Francisco	46.4	732,000
Seattle	83.7	502,000
Washington, DC	62.7	617,000

Source: Bureau of the Census, *Statistical Abstract of the United States, 1990.*

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